DEPUTY MINISTER'S REPORT
TO PREMIER CALVERT
ON SPUDCO

The Review Environment

On January 14, 2003 I was instructed by Premier Calvert to carry out a thorough review of the events related to government's management of its investment in support of the province's potato industry. This review was precipitated by criticism of government's involvement in the industry through the Saskatchewan Water Corporation, and specifically its operating division known as SPUDCO. Within the context of the criticisms of this investment in potato storage facilities three specific matters have generated significant public interest:

- Was the ownership structure of the storage facilities developed to avoid international trade investigation?
- Did the government knowingly violate its tendering policies with the use of non-union labour for construction?
- Was the nature of the business relationship with Con-Force Ltd. accurately portrayed?

The context of this review includes legal proceedings relating to the Government's involvement in the potato industry. The first action was commenced in April of 2000 by Judith River Farms Limited, Coteau Hills Potato Corporation, Lake Bend Potato Corporation and Newbridge Potato Corporation. The Plaintiffs in the first action were all participants in the formation of the Lucky Lake Farm and Water Partnership, who, with their general partner Lake Diefenbaker Potato Corporation, allegedly invested in the potato industry as a result of representations made by SaskWater and the Government. They further allege that because they invested in the potato industry they suffered the loss of their investment.

A second legal action was commenced by Mark Langefeld, Lake Bend Potato Corporation and Newbridge Potato Corporation in December of 2000. The second action is the derivative action whereby the named Plaintiffs were given leave to commence the action on behalf of the bankrupt Lucky Lake Farm and Water Partnership and Lake Diefenbaker Potato Corporation. The allegations in the second action are substantively the same as the first action.

To date, defences to the claims on behalf of both SaskWater and the Government have been filed. Extensive document disclosure has occurred whereby the Government and SaskWater have disclosed well in excess of 2,700 documents.

Mandate of the Review

At the Premier's request, in my capacity as Deputy Minister to the Premier, I have conducted a review of SPUDCO's investment in storage facilities with a view to describing the events, key decisions, and processes as they unfolded between 1997 and 1998.

Review Method

The review has consisted primarily of an examination of relevant Cabinet files, including Minutes, reports from the Chair of CIC, Decision items and Information Items; CIC files including Board minutes and Decision Items, Information Items and Reports; Saskatchewan Water Corporation files including Board Minutes, Decision Items, Information Items and Annual Reports; Reports of the Provincial Auditor; Hansard and the verbatim from various meetings of the Standing Committee on Crown Corporation; and a wide array of other documents from executive government related to government's potato strategy.

CHRONOLOGY OF EVENTS AND DECISIONS

Background

Since the 1960s provincial and federal governments have invested approximately $200 million in large-scale irrigation development in the Lake Diefenbaker Development Area (LDDA). Through the promotion of water-based economic development activities, governments hoped to strengthen the agricultural economy by diversification and maximizing the value of production on irrigated land.

Before 1996, SaskWater provided potato growers with financial support in the form of grants to support research and development and to assist potato growers with the cost of building the required infrastructure including storage to support the development of the potato industry.

In 1996 government's involvement with the potato industry changed when the Saskatchewan Water Corporation began potato production and processing trials with private sector growers. These efforts were designed to determine the economic viability of growing potatoes on irrigated land in Saskatchewan. SaskWater assessed the development of the potato industry and determined that the industry was of sufficient size and maturity to include it as a key strategy in the government's 1996 economic development strategy. Potato producers identified the potential of a french fry plant located in the Lake Diefenbaker area, involving substantial employment and development opportunities for the rural agricultural sector.

On November 27, 1996 the Cabinet Committee on Economic Development approved in principle the recommended Lake Diefenbaker Agri-Value Strategy.[1] The Department of Economic Development was designated as the lead department for the Agri-Value Strategy and an interdepartmental project team was tasked to develop a detailed plan to be presented to Cabinet by May 1997. [2]

The Lake Diefenbaker Agri-Value Strategy was expected to provide significant economic impacts, including $120 million of capital investment primarily from the private sector, 730 direct jobs, 2700 secondary jobs and 1295 person-years of construction employment at maturity. The development of the potato industry required increasing production levels to support a progression from fresh packing, to a flaking plant and finally to processing operations with a french fry plant. The french fry plant required an increase of potato production in the Lake Diefenbaker area from roughly 2,000 acres to 20,000 acres. The ultimate goal in this aggressive strategy was to develop an integrated potato industry that would be export-oriented, with a world scale french fry plant as its anchor. The french fry

[1] During the period August 6, 1996 to June 27, 1997 the Cabinet Committee on Economic Development consisted of Premier Roy Romanow, Chair; Hon. Dwain Lingenfelter, Vice-Chair; Hon. Bernhard Wiens; Hon. Janice MacKinnon; Hon. Eldon Lautermilch; and Hon. Eric Upshall.

[2] From May 20, 1992 to June 27, 1997 Hon. Dwain Lingenfelter served as Minister of Economic Development.

plant would produce 300 million pounds of french fries annually, with an estimated wholesale value of $150 million and a retail value of $1.1 billion.

Under the mandate of this strategy SaskWater's primary role was to contribute irrigation and agronomic services. It was also encouraged to establish joint ventures with private sector growers, help expansion, then cease operations letting natural commercial market interests carry on. Consistent with its mandate, joint venture production agreements were to be limited to three years.

SPUDCO

In support of this mandate and direction, on December 2, 1996 SaskWater's Board of Directors approved the establishment of SPUDCO as an operating division of SaskWater along with a three-year potato production plan.[3] On December 12, 1996 the CIC Board[4] confirmed the implementation of SPUDCO's three-year potato production plan with cash operating requirements funded through a revolving line of credit of up to $4 million. The Board also approved, in principle, SaskWater's participation in the development of field storage facilities with a maximum investment of $1 million.

On March 3, 1997 the SaskWater Board approved the recommendation of management[5] to enter into a business relationship with Con-Force Ltd. providing for:

- an investment of up to $2 million through a combination of equity and debt (assumed $1 million equity and $1 million debt) to acquire a 49% ownership interest in field storage facilities to support up to 2000 acres of potato production in the Lake Diefenbaker area; and
- an investment of up to $1 million through a combination of debt and equity to acquire a 49% ownership interest in storage to support the development of a fresh pack plant to be built by Sask Ida of Coteau Hills Limited Partnership (SIOCHP).

On April 3, 1997 a Cabinet Decision Item was prepared which requested Cabinet approval for SaskWater's proposal to:

- complete a business relationship in a series of new corporate entities with Con-Force Ltd., through the purchase of shares, to build and lease a maximum of three potato storage facilities; and

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[3] From April 16, 1996 to June 27, 1997 Hon. Eldon Lautermilch served as Chair of the SaskWater Board of Directors and Hon. Carol Teichrob served as Vice-Chair.

[4] From November 22, 1996 to June 27, 1997 the Board of Directors of the Crown Investments Corporation consisted of: Hon. Bernhard Wiens, Chair; Hon. Ned Shillington, Vice-Chair; Hon. Janice MacKinnon; Hon. Dwain Lingenfelter; Hon. Eldon Lautermilch; Hon. Carol Teichrob; and Hon. Clay Serby.

[5] During the period under review the key SaskWater officials were Brian Kaukinen, SaskWater's President and CEO, and Harvey Fjeld, Vice President of Irrigation and Agricultural Services.

- take an equity position of up to 49% in each of the three potato storage facilities with SaskWater's direct investment not to exceed $1 million per facility for a total of $3 million.

It was reported in the CDI that after negotiations with the banks, debt financing could only be arranged based on a direct lease from SaskWater. It was also indicated that Con-Force Ltd. was the only supplier capable of developing and constructing the three storage facilities between April 1997 and mid-August 1997. It was imperative that these construction deadlines could be met, as potato producers were not able to plant their crop unless potato storage facilities were to be available by harvest time.

On April 3, 1997 the CIC Board recommended that Cabinet approve SaskWater's recommendation to build and lease the proposed three storage facilities, subject to the following conditions:

- SaskWater obtaining the financing for the three potato storage facilities at $2.5 million each, with the total debt secured not to exceed $7.5 million;
- SaskWater entering into a capital lease and buy-back agreement with SIOCH (Sask Ida of Coteau Hills) for two of the storage units under commercially acceptable terms and conditions that would give due consideration to potential actions and interpretation under NAFTA.

The CIC Board also directed SOCO to explore the option of replacing SaskWater as the agency to invest in storage facilities.[6]

CIC commentary on the proposal notes the sense of urgency around this decision given the April deadlines for finalizing crop share agreements and construction plans. It also recognizes that for the short term SPUDCO appeared to be the only avenue to finance the three storage facilities and without the financing, potato producers cannot plant their crops as no storage facilities would exist in the fall of 1997. It was also recognized that while Con-Force was the only contractor identified with the experience to construct potato facilities in the time limit available, the lack of an open tender process would be a factor that may have to be addressed. Details of the ownership structure for the three storage companies were not described in the decision item beyond a brief reference that SaskWater was negotiating a business relationship with Con-Force Ltd. to build and operate the facilities.

[6] In the absence of the CIC Chair, the April 3 meeting was chaired by Minister Lingenfelter. The recommendation was moved by Minister Lautermilch and seconded by Minister Teichrob.

On April 9, 1997 Cabinet[7] considered the recommendation of the CIC Board along with the Cabinet Decision Item dated April 3, 1997. Further to these deliberations Cabinet requested:

- the Minister responsible for CIC to provide a summary of the due diligence respecting the parties involved and a summary of consultations undertaken with the seed growers; and
- the Deputy Minister to the Premier to report back on trade implications.

On April 15, 1997 Cabinet received the report on due diligence and consultations from SaskWater and a memo from the Deputy Minister of Intergovernmental Affairs on trade implications. Cabinet then authorized SaskWater to build and lease three potato storage facilities subject to the conditions recommended by CIC. Cabinet adopted the CIC Board recommendation directing SOCO to explore the option of replacing SaskWater as the agency to invest in the potato storage facilities.

On April 16, 1997 SaskWater President Brian Kaukinen signed a Memorandum of Understanding (MOU) with Con-Force Investments Ltd. The MOU, drafted on April 4 and approved in principle on April 7, sets out the framework for the relationship with Con-Force. It describes the project to construct storage facilities in the following terms:

> The project will initially involve the construction of up to three Facilities in 1997, each to be constructed and owned by a separate company jointly owned by SPUDCO and CFI (each a "Storage Co."). Each will be leased to SPUDCO and, in turn, SPUDCO will lease storage space in each Facility to farmers. The ownership of each facility will ultimately be transferred to farmers or investor groups. The project may involve the construction and ownership of additional facilities in future years as required...

Part Two of the MOU sets out the corporate structure and organization of the storage companies.

> SPUDCO and CFI will cause the incorporation of a series of Storage Co.'s, each of which will construct, own and control an individual facility. SPUDCO and CFI will subscribe for and purchase, for nominal consideration, common voting shares of each Storage Co., to be held 51% by CFI and 49% by SPUDCO.

The MOU further provided SPUDCO (SaskWater) with the right to purchase, at any time, at the original subscription price, all the shares of CFI in the capital of each storage companies, and the requirement to purchase all of CFI's shares in the capital of the

[7] In April 1997 Cabinet consisted of the following ministers: Premier Roy Romanow, Q.C.; Hon. Dwain Lingenfelter; Hon. Bernhard Wiens; Hon. Robert Mitchell, Q.C.; Hon. Janice MacKinnon; Hon. New Shillington; Hon. Pat Atkinson; Hon. Lorne Calvert; Hon. Eldon Lautermilch; Hon. Keith Goulet; Hon. Andy Renaud; Hon. Joanne Crofford; Hon. Carol Teichrob; Hon. Eric Upshall; Hon. Eric Cline; Hon. Lorne Scott; Hon. John Nilson; and Hon. Clay Serby.

companies, at the original subscription price, after ten years. CFI was required to act as developer and upon completion act as manager for each storage company, however beyond that it was not required to contribute capital or other financial assistance to the storage companies.

By April 22, 1997 the changed relationship with Con-Force Limited was being communicated to departmental officials involved in the Agri-Value Strategy. A note originating with a Department of Agriculture official referenced a call with Mr. Bryon Burnett, then Executive Project Leader for Community Economic Development and Food Processing with the Department of Economic Development. The note indicated that the arrangement with Con-Force had changed and that Con-Force would not be taking an equity position in the project.

On April 28, 1997 Minister Lautermilch responded to an inquiry from Mr. Elwood Sawby related to the storage facilities. Mr. Sawby contended that his company, Zipperlock Steel Buildings (1991) Ltd., would have built the facilities for considerably less than the estimated $2.3 million per structure. In this correspondence, drafted by an official from SaskWater, Minister Lautermilch noted: "The extent of the province's involvement is with SPUDCO, a division of SaskWater who is a minority partner in the new potato storage facilities."

On May 2, 1997 Mr. Zach Douglas, President of SOCO, responded to Cabinet's direction respecting the potential involvement of SOCO. In his memorandum to Deputy Minister to the Premier Greg Marchildon, Mr. Douglas noted that there was no upfront capital commitment from the beneficiaries and without such a commitment SOCO's investment criteria would not be satisfied. Mr. Douglas goes on to say that although no government guarantee is provided, SPUDCO's (SaskWater's) master lease means that government is responsible for the total amount and that this did not fit within the SOCO mandate as only risk sharing arrangements were permitted.[8]

The Order-in-Council (O/C) authorizing the share purchase relating to the Con-Force business relationship was signed on May 22, 1997.[9] The O/C authorized SaskWater to purchase shares not exceeding $1 million in each of three storcos - Riverhurst Potato Storage Inc., Tullis Potato Storage Inc. and Lucky Lake Potato Storage Inc.

On June 4, 1997 SaskWater's Board of Directors approved Unanimous Shareholders Agreements with Con-Force Investments (CFI) and each of the storage companies. A principal component of the Agreements was the provision enabling SaskWater to purchase CFI's 51% ownership interest in each of the storage companies at any time, and in any event at the end of ten years for the original subscription price of the shares. Management was also authorized to enter into a ten-year lease with each of the storage

[8] This memorandum was copied to Hon. Dwain Lingenfelter, Minister responsible for SOCO; John Wright, President, CIC; and Brian Kaukinen, President, SaskWater.

[9] This O/C was signed by Ministers Lautermilch (SaskWater) and Wiens (CIC) and Premier Romanow.

companies reflecting the capital cost of the facility, and subsequently enter into subleases and purchase agreements for two of the three storage companies. The shareholder agreement reviewed by the SaskWater Board of Directors does not refer specifically to the subscription price of the shares. This detail was contained in an appendix to the final agreements which were signed by senior officials of SaskWater and Con-Force on June 26, 1997. [10]

Financial and Management Audit and Review

On December 4, 1997 the SaskWater Board approved the production plan for 1998 based on the assumption that four new storage facilities could be built at a maximum of $13 million with a program for sale of three of the new storage facilities and finalization of the sale of one of the 1997 storage units. On March 5, 1998 the Board approved a revised 1998 production plan for SPUDCO.

On April 24, 1998 the CIC Board of Directors[11] agreed to SaskWater's proposal to build four storage facilities. This decision was taken after a very substantial review by CIC officials and three meetings of the Board of Directors. On April 16 CIC officials presented an alternative recommendation providing for the construction of only one new storage facility. CIC's Board requested further information on the impact of not proceeding with four facilities. The information provided by SaskWater indicated that the financial impact of not proceeding would be substantial. Unrecoverable costs would be approximately $500,000 for SPUDCO and $3.3 million for the private sector growers. The flaking plant planned for construction by Lake Diefenbaker Potato Corporation would be deferred, as would the plans for the french fry plant. The CIC Board of Directors approved SaskWater's proposal with the following stipulations:

- that SaskWater obtain the financing for the four potato storage facilities, with the total debt secured not to exceed $14.5 million including equipment; and
- that SaskWater proceed with the development of an orderly exit plan which removes them from commercial production, commercial storage and marketing of potatoes by the end of the 1999 business cycle.

The CIC Board further recommended that Cabinet support the establishment of a working committee lead by Saskatchewan Economic and Co-operative Development with representation from Crown Investments Corporation, Saskatchewan Opportunities Corporation, Saskatchewan Government Growth Fund, Ag Equity Fund and SaskWater, with the mandate to develop, coordinate, and manage an integrated "Investment

[10] On June 27, 1997 Hon. Maynard Sonntag replaced Hon. Eldon Lautermilch as Chair of the SaskWater Board of Directors; Hon. Dwain Lingenfelter replaced Hon. Bernhard Wiens as Chair of CIC; and Hon. Janice MacKinnion assumed responsibility for the Department of Economic and Co-operative Development.

[11] From June 27, 1997 to September 21, 1998 the Board of Directors of CIC consisted of Hon. Dwain Lingenfelter, Chair; Hon. Bernhard Wiens, Vice-Chair; Hon. Janice MacKinnon; Hon. Ned Shillington; Hon. Eldon Lautermilch; and Hon. Eric Cline.

Attraction Strategy", identifying sources of both debt and equity funding for all future facility and infrastructure requirements including storage, fresh pack and french fry plants.

The Board also directed CIC officials to lead a financial and management audit and review of the current business arrangements, agreements, contracts, financial reports, and projections that comprise SaskWater's potato storage business, and return to the CIC Board with recommended alternatives for future business relationships.[12]

On April 28, 1998 CIC's recommendation of April 24 was approved by Cabinet,[13] subject to SaskWater:

- obtaining the financing for the four storage facilities, with a total debt secured not to exceed $14.5 million; and
- proceeding with the development of an orderly exit plan which removed them from commercial production, commercial storage and marketing of potatoes by the end of the 1999 business cycle and further to provide CIC with a progress report within three months.

At the same time, Cabinet endorsed the establishment of a working committee lead by the Department of Economic and Co-operative Development to develop, co-ordinate and manage an integrated "Investment Attraction Strategy" and to identify sources of both debt and equity funding for all future facility and infrastructure requirements including storage, fresh pack and french fry plants.

Cabinet was informed that the CIC Board had directed CIC officials to undertake a comprehensive financial and management review of the current business arrangements, agreements, contracts, financial reports and projections related to SaskWater's potato storage business and to return to CIC Board with recommended alternatives for future business relationships.

Cabinet further directed CIC to request Intergovernmental and Aboriginal Affairs to provide a thorough analysis of any trade implications. This analysis was provided by Deputy Minister of Intergovernmental and Aboriginal Affairs Brent Cotter in memorandum dated June 15, 1998 to John Wright, President and CEO of CIC.

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[12] The meeting was attended by Hon. Dwain Lingenfelter, Chair; Hon. Bernhard Wiens (Phone); Hon. Ned Shillington; Hon. Janice MacKinnon; and Hon. Eric Cline.

[13] In April 1998 Cabinet consisted of the following ministers: Hon. Roy Romanow, Q.C.; Hon. Dwain Lingenfelter; Hon. Bernhard Wiens; Hon. Robert Mitchell, Q.C.; Hon. Janice MacKinnon; Hon. Ned Shillington; Hon. Patricia Atkinson; Hon. Lorne Calvert; Hon. Eldon Lautermilch; Hon. Keith Goulet; Hon. Joanne Crofford; Hon. Carol Teichrob; Hon. Eric Upshall; Hon. Eric Cline; Hon. Lorne Scott; Hon. John Nilson; Hon. Clay Serby; Hon. Judy Bradley; Hon. Maynard Sonntag.

In May 1998 negotiations involving the priv e sector potato producers, SaskWater and the company interested in french fry production broke off and the company announced its intention to locate in Alberta.

The financial and management audit and review was conducted by CIC between April 29 and July 6, 1998. In undertaking its review CIC engaged Ernst and Young to report on internal control systems, the adequacy of decision-making processes, corporate governance and management practices.

Key conclusions of the Ernst and Young report are summarized as follows:

- Similar to many relatively new businesses, SPUDCO was experiencing some operational growing pains and some changes to financial reporting and internal controls were recommended. However the issues identified were, according to Ernst and Young, resolvable by management.
- Overall the design of SaskWater's internal controls related to SPUDCO were adequate; however the unique nature of SPUDCO's business created the need for additional internal controls.
- SaskWater's financial statements use equity accounting for the investment in the storage facilities which results in SaskWater showing an investment of only $147 in the three storcos constructed in 1997. The reference to CFI as a "partner" may create the impression that the risks and returns related to the storcos are shared by SaskWater and CFI despite the fact the SaskWater bears 100% of the risk.
- Although management provided the SaskWater Board with required information about SPUDCO, corporate governance could be more effective. Clearer, more concise communication to the SaskWater Board and CIC by management in a more timely fashion would ensure the Board has a clear understanding of the principal risks of all aspects of the SPUDCO operations.

Ernst and Young reported that the nature of the involvement between SPUDCO and CFI including their investment, sharing of risk and fees had not been clearly communicated in the documentation. As a participant in the storage companies, CFI acted as a construction manager, supplied the pre-cast concrete and upon completion provided management services to each of the seven storage companies.

According to Ernst and Young, management at SaskWater indicated the ownership structure of the storcos provided a number of potential benefits including "avoidance of international trade investigations, use of non-unionized labour for construction, and the optics of significant private sector investment".

CIC's financial and management review of SPUDCO, prepared by CIC's Executive Director of Investments Michael Fix, contained 46 recommendations relating to governance, controls and monitoring, decision making processes and management practices. The report was presented to the CIC Board of Directors on July 9, 1998. The Board expressed serious concerns about the contents of the report and directed

SaskWater's Board of Directors to determine accountability for the decisions referenced in the report, to develop a plan to rectify the concerns raised, and to provide a progress report on its review of accountability and future actions by August 20, 1998 with a final report by October 5, 1998.

On July 14, 1998 an O/C was issued authorizing the purchase of shares up to $1 million in each of two new storage companies (Broderick Potato Storage Inc. and Valley Potato Storage Inc.) for a total not to exceed $2 million. In the aftermath of the financial and management review and the concerns related to the business arrangement with Con-Force CIC advised SaskWater to take no action on the O/C and no new shares were purchased for the 1998 construction program.

On July 23, 1998 Mr. Kaukinen was replaced as President and CEO of SaskWater by Mr. Ron Styles. On January 1, 1999 Mr. Fjeld, Vice President of Irrigation and Agricultural Products, accepted an early retirement package and was replaced in February by Mr. Dale Sigurdson.

The Failure of Lake Diefenbaker Potato Corporation

During the summer of 1998 SaskWater officials became increasingly aware of the financial problems facing the Lake Diefenbaker Potato Corporation. On October 29, 1998 CIC received a report on the impact of the current financial state of Lake Diefenbaker Potato Corporation (LDPC) on SPUDCO's short term business options. CIC was advised that SaskWater officials were considering options to sustain LDPC's operations until financing and cash flow issues could be addressed.

On November 4, 1998 SaskWater's Board of Directors approved the corporation's participation in a re-structuring plan for LDPC designed to address the financial instability being experienced by the potato producers.

On November 13, 1998 the CIC Board considered SaskWater's recommendation to participate in LDPC's financial re-structuring and recommended that Cabinet approve SaskWater's participation on the following terms and conditions:

- SaskWater transfer the Lucky Lake Potato Terminal to LDPC for the original capital cost (approximately $5.8 million);
- SaskWater finance the transfer through a $2.8 million second mortgage and a $3 million debenture securing a third position on all property; and
- SaskWater convert the existing accounts receivable owed by LDPC into a debenture to a maximum of $1.5 million.

On November 17th, 1998 Cabinet approved SaskWater's participation in the financial restructuring of LDPC on the terms and conditions recommended by CIC.

On January 19, 1999 an O/C was issued authorizing SaskWater to acquire the Lucky Lake Potato Terminal from Lucky Lake Potato Storage Inc. and to sell it to LDPC; to provide financial assistance in the form of subordinated security for the purchase price in an amount not to exceed $2.5 million and to acquire LDPC debentures of not more than $5 million.

In early May 1999 LDPC declared bankruptcy.

On September 28, 1999 CIC considered a request from SaskWater's Board of Directors to acquire certain assets associated with the LDPC bankruptcy and that SaskWater be subsequently permitted to dispose of a subset of those assets. CIC recommended to Cabinet approval for the acquisition of the Fresh Pak plant and equipment, the flaking plant and Coteau Hills storage facility from the Royal Bank and FCC for $1.225 million; and the sale of a portion of these assets, being the Fresh Pak plant and equipment to Pak-Wel Produce Limited of Alberta for $1 million.

On October 5, 1999 Cabinet received an information item from Minister Sonntag advising of SaskWater's strategy for completing the LDPC bankruptcy process. The enabling O/C dated October 5, 1999 authorized SaskWater to acquire certain property and to resell a portion of this property.

In November 1999 SaskWater approached CIC with a request for a cash injection of $17.8 million which was denied, pending the completion of government's review of SaskWater's mandate.

Saskatchewan Valley Potato Corporation

Subsequent to the government's mandate review, the CIC Board considered a restructuring plan for SaskWater/SPUDCO. It was felt that the commercial aspects of the potato industry could be better served under the CIC commercial mandate. On April 6, 2000 CIC recommended the establishment of a new corporate subsidiary through CIC III and the transfer of all SaskWater's assets and liabilities related to its potato operations to CIC.

On April 10, 2000 Cabinet approved the restructuring plan. The associated O/Cs were passed on May 10 and June 28. On August 2, 2000 Saskatchewan Valley Potato Corporation's (SVPC) line of credit was set at $2 million, and on December 21, 2000 CIC was authorized to guarantee up to $5.5 million to CIBC for Saskatchewan Valley Potato Corporation mortgages. On July 10, 2001 SVPC's line of credit was extended to $3 million.

On November 1, 2001 CIC approved the implementation of a new business strategy for SVPC to reduce and ultimately remove the corporation from direct involvement in potato production and to write-down the value of storage assets by $14.3 million from $17.4 million to $3.1 million.

OBSERVATIONS

International Trade Concerns

It has been publicly suggested that the ownership structure of the storage companies was deliberately designed to circumvent international trade laws. In both 1997 and 1998 Cabinet was assured that the risk of international trade sanctions would be minimized as long as the storage facilities were operated on a commercial basis. SPUDCO subleased the potato storage facilities to Lake Diefenbaker Potato Corporation on commercial lease terms and the ability of the subtenant to meet its commercial obligations was directly dependant upon the ability of the potato producer to grow and successfully market their crop.

Notwithstanding the belief by SaskWater officials (as reported in Ernst and Young) that private sector participation might somehow reduce the risk of trade investigations by the United States, Cabinet understood that the real issue was subsidization and the defence against any allegations of unfair trade practices would require a demonstration that the storage facilities were provided to producers on reasonable commercial terms. Nevertheless, in the context of intensifying trade disputes between Canada and the United States it is hardly surprising that officials would make every possible effort to protect producers from any such allegations of unfair trade practices.

Crown Tendering

In reviewing this segment of the materials, it is important to be aware that the crown tendering agreement was not a legislated requirement incorporated in act or statute. It was a government policy operationalized through agreement with the Saskatchewan building trades, the Construction Labour Relations Association of Saskatchewan Inc. and some of the crowns including SaskWater. As government policy it was a guide for future actions. The manner in which the storage facilities were constructed did not conform with government tendering policy and the requirements under CCTA were not followed. This was not a violation of any law, but rather a departure from policy.

Given the circumstances in which the storage facilities were constructed, particularly the desire for private sector participation and the ongoing search for an equity investor, the uncertainty on the financial arrangements with the bank, and the urgency of decision making around the construction schedule, the departure from government tendering guidelines does not appear to be unreasonable. The decision not to tender the construction of the storage facilities was essentially driven by the fact that timelines were so tight that tendering the construction would have meant that the facilities would not have been completed by harvest time.

While it is always more difficult to defend contracts that are let outside the standard tendering practices of government, Con-Force Ltd. was the only identified contractor experienced in the construction of the proposed storage facilities. The Ernst and Young

audit reported that based on the provisions for engineering services as well as the project management services, the fee charged by CFI appeared reasonable. The provisions of the corporate development and management services arrangements were identified as a concern and Ernst and Young included a number of recommendations related to the services provided and reporting requirements.

Ownership Structure of the Storcos

Initial documentation within SaskWater indicates that equity investment by shareholders was anticipated in storage facility corporations that were to be formed. The April 3, 1997 CDI shows that the ownership structure was an evolving issue, which in large part was mandated by bank financing requirements. The CDI contained the public policy proposal to build and lease storage facilities. It referenced the bank requirement for a SPUDCO master lease, but it did not articulate a clearly defined strategy. The document is unclear as to the specifics of financing and the level of private sector participation.

The pressures of implementing the potato shed development in time to allow the potato producers to meet the spring seeding deadlines is evident in the activities of March and April 1997. SaskWater proceeded with a contract with Con-Force Ltd. which permitted the development and construction of the storage facilities. At the same time, the arrangement permitted the introduction of a third party private sector investor if terms could be arrived at and the finalization of bank financing. SPUDCO was clearly looking for a joint venture participant (partner) who would be involved in the storage shed companies, however this could not be secured in 1997.

In the context of the temporary three year production plan and the emphasis on moving the facilities into the private sector as quickly as possible, the storco structure represented a facilitating device to introduce a private partner, an important objective in the success of any exit strategy. The O/C issued on May 22, 1997 was permissive. Following the plan set forth in April it permitted SaskWater to invest up to $1 million through a share purchase in each of the three storcos. This was one component of a larger strategy designed to facilitate the construction of the necessary storage infrastructure. It was consistent with the government's objective to share the risk involved with the private sector and ultimately to remove itself entirely from the commercial operation of the storage facilities.

Description of the Private-Public Partnership

Whether the SaskWater reference to partner is in any way material, or whether the evolving nature of the corporate governance structure for the storage facility companies was misleading so as to cause loss or harm to third parties is one of the issues of the legal action and is a matter that will be determined by the court.

In the broader sense of the word, government's strategy was designed to facilitate the co-ordination of activities by a wide range of interests, organizations and agencies in pursuit

of a common objective, and in this sense it was conceptualized and characterized as an industry partnership. With specific reference to the business relationship with Con-Force, it is clear that during the initial decision making process (March through May 1997) negotiations with Con-Force Ltd. were ongoing and expectations about the nature of the relationship changed substantially. While in March there was an expectation that Con-Force would be a real partner with an equity investment, by early April when the MOU was drafted this relationship had changed.

The response of Minister Lautermilch to Mr. Sawby is troubling. While it would have represented an accurate understanding of the evolving relationship in March, by mid-April key SaskWater officials were aware that the relationship with Con-Force was not an ordinary commercial one where risk and rewards were shared. CIC and Cabinet understood that SaskWater was assuming all of the risk associated with the construction of the storage facilities. The Minister's correspondence was less than forthcoming in terms of the arrangement with Con-Force. The characterization of this business relationship as a partnership where government enjoyed a minority interest was inappropriate.

This description was re-inforced when the President of SaskWater in an interview with Leader Post journalist Bonnie Braden (May 27, 1997) is quoted as saying: "In fact this investment does make a profit for both ourselves .... and our partners." The article goes on to note that Con-Force Structures, a Regina building construction company, will be the government's partner in the venture. Further, the article notes "Each of the three buildings will cost $2.5 million, so the builders will have to find some additional financing, he [Kaukinen] added."

The Public Interest and Accountability

With the bankruptcy of Lake Diefenbaker Potato Corporation in May 1999 considerable attention was directed toward SPUDCO and its investment in the potato industry. Opposition MLAs called for a special audit by the Provincial Auditor and an independent public inquiry. The Provincial Auditor, very much attuned to the public attention SPUDCO had attracted, conducted an independent audit in 1999 and included his finding on the management of government's investment in the potato industry in the 2000 Spring Report.

The Provincial Auditor reported that while some specific objectives for SaskWater's planned involvement in the potato industry were clear and measurable, others were not. SaskWater did not set out clearly its objectives relating to the extent of financial involvement in building storage facilities. In its original 1997 business plan (approved in December 1996) SaskWater had expected the private sector to build storage facilities, with government to invest not more than $1 million. By April 1997 SaskWater changed its plans and partnered with a private sector company to construct three facilities that cost $9.1 million. Notwithstanding the deficiencies identified in 1997 and 1998, the Auditor noted that the 1999 business plan had identified clear and measurable objectives.

The Auditor also found that management did not provide the SaskWater Board with a comprehensive assessment of the risks that SaskWater faced before it approved the 1997 and 1998 business plans. However, by late 1998, the Auditor observed that the Board was receiving a comprehensive risk analysis from management. Additionally, investment monitoring was found to be deficient in 1997 and 1998 and reports on the status of the investment did not include adequate information to monitor and control the investment. By late 1998 management was periodically identifying and evaluating risks related to investment objectives. The Auditor noted that by the fall of 1998 the appropriate changes had been made and that adequate rules and procedures were in place.

The recommendations arising from CIC's financial and management audit and review were acted on very quickly. Deficiencies in internal controls and monitoring systems were remedied; governance processes were tightened up dramatically, and those issues associated with clear, concise, timely communication between management and the Board of Directors were quickly resolved as new management personnel were put in place at SaskWater. Consolidated accounting was implemented the next year and SaskWater's 1998 financial statements provide full and complete disclosure of the investments in potato storage facilities and the associated risks and contingent liabilities.

Governance Improvements

My observations on government's experience with SPUDCO would not be complete without reference to the broader environment related to crown governance and the timeframe in which these particular events unfolded. In 1996 government embarked on a comprehensive review of the Crown sector. The general findings of the review confirmed the public remained satisfied with public ownership, the crowns were in sound financial shape and reasonably positioned to meet the changes of the future without significant risk to their overall value. The governance model in place at the time was not as effective as it might have been and the review concluded that substantial improvements were necessary in governance and accountability.

In June of 1997 government outlined its response to the review in "Saskatchewan's Crown Corporations: a New Era" which provided a refreshed mandate for public enterprise and a new governance model for Crown operations. The new governance model focused on clear mandates with well articulated strategic objectives, real consequences for performance and accountability to the customer and shareholder.

Within this context CIC embarked on a five-year process to fully implement comprehensive improvement to the planning, performance management, accountability and governance structures for its holdings. Key elements of Saskatchewan's governance model include:

- Application of an accountability matrix for decision making that reflects the unique relationship between Cabinet, CIC and the subsidiary Crowns;

- An integrated sector Strategic Planning and Performance Management System;
- Ongoing investment in Director training and development;
- Adoption of due diligence guidelines and investment policies;
- Development of communication, reporting and information mechanisms between all stakeholders; and
- Public accountability through reporting and disclosure that meets or exceeds private sector standards.

At the organization level, CIC was completely restructured to reflect the changing requirements of the new governance model and the resulting improvements in governance and accountability have been significant. CIC has demonstrated an expertise in leading edge governance practices that is recognized nationally and internationally. The Conference Board of Canada places CIC governance practices in the top quartile compared to private and public sector boards in Canada. Moreover, the Conference Board has also rated CIC and its subsidiary crowns as performing well against leading private sector peers in terms of reporting and disclosure practices.

CONCLUSION

I have looked at the three specific matters raised in the criticism of the Spudco experience.

In both 1997 and 1998 Cabinet was assured that the risk of international trade sanctions was minimal as long as the storage facilities were operated without subsidy. This was the case.

Construction of the storage facilities was done outside the crown construction tendering agreement. Given the urgency of finalizing crop sharing arrangements and the necessity to commence construction, this action does not appear to be unreasonable.

The relationship with Con-Force was inappropriately portrayed as a relationship where the risks and rewards were shared.

LIST OF DOCUMENTS

Lake Diefenbaker Agri-Value Strategy (November 27, 1996).
Crown Investments Corporation Board Minute (December 12, 1996)
Saskatchewan Water Corporation Board Minute (March 3, 1997)
Cabinet Decision Item (April 3, 1997)
Crown Investments Corporation Board Item and Minute (April 3, 1997)
Cabinet Minute (April 9, 1997)
Report to Cabinet: Due Diligence and Consultation (April 14, 1997)
Report to Cabinet: Trade Impacts (April 14, 1997)
Cabinet Minute (April 15, 1997)
Memorandum of Understanding between Con-Force Ltd. And SaskWater (April 7, 1997)
Department of Agriculture Note to File (April 22, 1997)
Ministerial correspondence to Mr. Elwood Sawby (April 28, 1997)
Memorandum from Mr. Zach Douglas (May 2, 1997)
Order-in-Council Fact Sheet (May 6, 1997)
Order-in-Council (May 22, 1997)
Leader Post article (May 27, 1997)
Saskatchewan Water Corporation Topic Summary and Board Minute (June 4, 1997)
Unanimous Shareholder Agreement (June 26, 1997)
Department of Economic Development, Progress Report: Lake Diefenbaker Agri-Value Strategy (February 1998)
Crown Investments Corporation Decision Items (April 16, 23 and 24, 1998)
Crown Investments Corporation Board Minute (April 24, 1998)
Cabinet Decision Item (April 28, 1998)
Memorandum from Mr. Brent Cotter (June 15, 1998)
Ernst and Young Report on SPUDCO Review (June 25, 1998)
Crown Investments Corporation Financial and Management Review (June 25, 1998)
Order-in-Council (July 14, 1998)
Saskatchewan Water Corporation Decision Item (October 5, 1998)
Crown Investments Corporation Board Information Item (October 29, 1998)
Crown Investments Corporation Decision Item (November 13, 1998)
Order-in-Council (January 19, 1999)
Crown Investments Corporation Information Item (February 11, 1999)
Order-in-Council (October 5, 1999)
Orders-in Council (May 10, June 28, August 2, December 21, 2000 and July 10, 2001)